

IT 98-7

Tax Type: INCOME TAX

**Issue: Financial Organization(s) (Credit Card Banks)
Audit Methodologies and/or Other Computational Issues
Replacement Tax Investment Credit/Property Used In Retailing**

**STATE OF ILLINOIS
DEPARTMENT OF REVENUE
ADMINISTRATIVE HEARINGS DIVISION
CHICAGO, ILLINOIS**

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS, Petitioner)	
)	
)	No.
)	
v.)	FEIN:
)	
XYZ COMPANY, INC., Taxpayer)	Administrative Law Judge
)	Linda K. Brongel

RECOMMENDATION FOR DISPOSITION

APPEARANCES: Richard Lipton and Jane May of Sonnenschein Nath & Rosenthal for XYZ COMPANY, INC.; Robert C. Asbille, Special Assistant Attorney General, for the Illinois Department of Revenue.

SYNOPSIS:

On December 9, 1994, the Department of Revenue issued a Notice of Deficiency for the years ended January 27, 1990, February 2, 1991 and February 1, 1992 against XYZ COMPANY, INC. ("Taxpayer" or "XYZ") for additional tax of \$40,849 plus interest and Section 1005 penalty. This Notice was protested on February 7, 1995.

The issue herein is whether certain assets of XYZ are qualifying assets for the investment tax credit. In addition, taxpayer has protested the Department's imposition of Section 1005 penalties.

On consideration of these matters, it is recommended that this matter be resolved in favor of the taxpayer in part and in favor of the Department in part.

FINDINGS OF FACT:

1. XYZ owns approximately 4,000 retail shoe stores throughout the country. XYZ stores are self-service discount shoe stores. (Tr. p. 193)

2. All of the XYZ inventory is kept on the sales floor. Approximately 90 percent of the store is selling floor. The remainder of the physical space of the store consists of an area for a desk, cleaning supplies and a lavatory. (Tr. p. 194)

3. The assets on which the Department has denied the investment credit fall into the following categories:

- Conveyer lifts
- Capitalized supplies and small tools
- Exit lights
- Lease buy-out
- Legal services and litigation
- Maintenance kits
- Safes
- Security equipment
- Signs
- Telephones
- Trash removal
- Vacuum cleaners
- Wire receivers or motion detectors

(Tr. pp. 195-205, Taxpayer's Ex. No. 7)

4. The conveyer lifts were used in the downtown stores that were on more than one floor to move merchandise between the floors of the store. (Tr. p. 196)

5. The category of capitalized equipment included supplies and painting expenses, shoe benches, step ladders, towel repair kits, and other miscellaneous assets which were capitalized for federal tax purposes. (Tr. p. 197)
6. Exit lights are required by building code to mark the exits to a building. (Tr. p. 198)
7. The lease buy-out was related to the acquisition of a lease for a particular store. (Tr. pp. 198-199)
8. Legal services, litigation and reimbursement of landlord would involve title searches and other legal expenses involved with the acquisition of a lease that were capitalized for federal tax purposes. (Tr. p. 199)
9. Maintenance kits were a standard supply kit that was sent from the home office whenever a new store opened that included cleaning supplies, a broom and a mop. (Tr. pp. 199-200)
10. The safes were of two types. One had electronic controls and could only be opened at certain times of the day. The other type of safe was a floor safe. Safes were necessary to XYZ' operations since it is primarily a cash and carry business. Every store had a safe as part of its normal security system. (Tr. pp. 200-201)
11. Security equipment included cameras and merchandise tags which would set off an alarm at the front of the store if they were not removed by a sales person. (Tr. p. 201)
12. The signs were of two types. The ones that exceeded \$1,500 in cost are exterior signs with the XYZ logo. The smaller dollar value signs were interior signs which were necessary because XYZ is a self-service operation. These signs would advertise special promotions or special prices and would be placed on the wall or on the top of the merchandise rack. (Tr. pp. 201-202)
13. The trash removal had to do with capital costs associated with a lease. (Tr. pp. 203-204)

14. The vacuum cleaners were used exclusively in the store. (Tr. p. 204)
15. The wire receivers acted to turn off the lights if there was no motion detected. The devices were used to conserve electricity. (Tr. p. 205)
16. Taxpayer has been audited by the IRS for many years and has reached an agreement regarding asset capitalization which determines whether assets are §1245 or §1250 property. All of the XYZ assets which are at issue were included on taxpayer's federal depreciation schedule. (Tr. pp.195-204)

CONCLUSIONS OF LAW:

The taxpayer has claimed the Personal Property Tax Replacement Income Tax credit for property placed in service in the XYZ shoe stores. Qualified property for purposes of the credit is defined by §201(e)(2).¹

The term "qualified property" means property which:

- (A) is tangible, whether new or used, including buildings and structural components of buildings;
- (B) is depreciable pursuant to Section 167 of the Internal Revenue Code, except that "3-year property" as defined in Section 168(c)(2)(A) of that Code is not eligible for the credit provided by this subsection (e);
- (C) is acquired by purchase as defined in Section 179(d) of the Internal Revenue Code;
- (D) is used in Illinois by the taxpayer in manufacturing operations or in mining coal or fluorite, or in retailing; and
- (E) has not previously been used in Illinois in such a manner and by such a person as would qualify for the credit provided by this subsection (e) or subsection (f).

¹ Unless otherwise noted, references to sections are to the Illinois Income Tax Act, Rev. Stat. 1991, Ch. 120, §1-101, et seq., the law in effect during the tax years in question. The statute regarding the personal property tax replacement income tax investment credit is now found at 35 ILCS 5/201(g).

The taxpayer's manager of taxes testified that each and every item on which the credit was claimed came from taxpayer's federal depreciation schedule, and thus qualifies as depreciable property pursuant to Section 167 of the Internal Revenue Code (as required by §201(e)(2)(B)).

The primary issue here relates to §201(e)(2)(D) which requires that the property be used in Illinois by a taxpayer in its manufacturing operations, in mining coal or fluorite, or in retailing. All of the assets in question on which XYZ claimed investment tax credit are located at the site of the retail store. Taxpayer's position is that since the property is used by the retailer in furtherance of its operations, it is eligible for the credit. The Department looks to its regulation (86 Ill. Admin. Code ch. I, Sec. 100.2100(c)(9)) which requires the property be directly related to the sale of products.

Retailing is defined by §201(e)(3) as "the sale of tangible personal property or services rendered in conjunction with the sale of tangible consumer goods or commodities." In the recent case American Stores v. Department of Revenue, 1998 Ill. App. LEXIS 272 (5th Dist. 1998), the Illinois Appellate Court held that the "statute simply requires that the property be used in the sale of tangible personal property, or in services rendered in conjunction with such a sale." Items which the court found to qualify for the replacement tax credit included warehouse equipment, transportation equipment and office equipment.

The property at issue here is located at the retail site of the taxpayer. The conveyer lifts are used to move inventory from one floor to another. The signs are either exterior signs with the XYZ logo or interior signs which are used to advertise special promotions or special prices and are placed on the wall or on the top of the merchandise rack, and are necessary because XYZ is a self-service operation. The capitalized supplies and small tools included supplies and

painting expenses, shoe benches, step ladders, towel repair kits, and other miscellaneous assets which were capitalized for federal tax purposes, some of which were used on the selling floor (i.e., shoe benches) and some of which were used for maintenance purposes (i.e., step ladders). Exit lights are required by building code to mark the exits to a building. Maintenance kits are a standard supply kit that is sent from the home office whenever a new store opened that includes cleaning supplies, a broom and a mop. The vacuum cleaners are used exclusively in the store. Every store had a safe as part of its normal security system. Safes are integral to XYZ' retail operations since it is primarily a cash and carry business. Security equipment includes cameras and merchandise tags which set off an alarm at the front of the store if they are not removed by a sales person. Telephones are a necessary component of the retail business whether located on the selling floor or in a backroom. The wire receivers act to turn off the lights if no motion is detected as a method of conserving electricity. The above property on which the investment credit was claimed fall squarely within the American Stores decision and qualify as property used in retailing.

Other items are capitalized costs which were related to the leasehold of the store and were deemed to be subject to depreciation for federal income tax purposes. The lease buy-out was related to the acquisition of a lease for a particular store. Legal services, litigation and reimbursement of landlord would involve title searches and other legal expenses involved with the acquisition of a lease that were capitalized for federal tax purposes. The trash removal had to do with capital costs associated with the acquisition of a lease.

According to §201(e)(2), qualified property must be tangible property. The only evidence in the record regarding this property is taxpayer's tax manager's testimony that the IRS reviewed the depreciation schedules and considered all items listed to be §1245 or §1250

property as well as his description of the items. Based on his testimony, it appears that these lease costs relate to the acquisition of the leasehold, however, rather than to leasehold improvements, and therefore should be classified as intangible property.

From the testimony presented, it is unclear what the true nature of the property is. Since the credit is only allowed on tangible property, taxpayer has failed to present sufficient evidence to rebut the Department's prima facie case as regards these items.

Regarding the imposition of penalties, Section 1005 of the Illinois Income Tax Act provides that:

...If any amount of tax required to be shown on a return prescribed by this Act is not paid on or before the date required for filing such return (determined without regard to any extension of time to file), a penalty shall be imposed at the rate of 6% per annum upon the tax underpayment unless it is shown that such failure is due to reasonable cause. This penalty shall be in addition to any other penalty determined under this Act...

Under federal case law, "reasonable cause" includes taking a good faith position on a tax return. See I.R.C. Section 6664(c). In general, if there is an honest difference in opinion between the taxpayer and the IRS regarding the correct amount of tax, no penalty is imposed. As a result, no penalty would be imposed due to a deficiency arising from a good faith tax return position with regard to law or facts. See, Ireland v. Commissioner, 39 T.C. 978 (1987); Webble v. Commissioner, 54 T.C.M. 281 (1987); Balsamo v. Commissioner, 54 T.C.M. 608 (1987).

As to the Section 1005 penalty for the years at issue, taxpayer's position on its tax returns was that all items included on its federal depreciation schedule and used at the retail site are eligible for the investment credit. While I disagree with taxpayer's position as regards the lease acquisition costs, taxpayer's position was taken in good faith. Consequently, taxpayer has offered reasonable cause to abate the Section 1005 penalty.

WHEREFORE, for the reasons stated above, it is my recommendation that the Notice of Deficiency should be cancelled as regards the following items:

- Conveyer lifts
- Capitalized supplies and small tools
- Exit lights
- Maintenance kits
- Safes
- Security equipment
- Signs
- Telephones
- Vacuum cleaners
- Wire receivers or motion detectors

As to the following items the Notice of Deficiency is affirmed:

- Lease buy-out
- Legal services and litigation
- Trash removal

The §1005 penalty should be abated for reasonable cause.

Date:

Linda K. Brongel
Administrative Law Judge

